



In The
SUPREME COURT OF THE UNITED STATES

October Term, 1942

No.

CENTRAL WEST COAL COMPANY, a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

**Brief in Support of Petition for
Writ of Certiorari.**

I.

OPINION OF THE COURT BELOW.

The opinion of the Circuit Court of Appeals for the Seventh Circuit is not as yet reported.

II.

JURISDICTION.

The decision of the Circuit Court of Appeals sought to be reviewed was entered November 11, 1942. The jurisdic-

tion of this court is invoked under Section 240 of the Judicial Code, as amended (28 U. S. C. A. 347, 350) and Rule 38 of the Rules of the Supreme Court.

III.

STATEMENT OF FACTS.

The facts have been sufficiently stated under the heading "A" in the Petition.

IV.

ASSIGNMENT OF ERRORS.

The Circuit Court of Appeals erred:

1. In holding that the provisions of the Articles of Incorporation set out in the preferred stock certificates prohibiting payment of dividends on the common stock until dividends on the preferred and cumulations had been paid, do not constitute a contract within the meaning of Section 26 (c) (1) of the Revenue Act of 1936.

2. In not adopting the construction placed upon the disputed trust deed provisions adopted by the parties, i.e., no dividends could be paid on the common stock until the principal then maturing and interest and charges had been paid by Petitioner out of earnings.

V.

A R G U M E N T .

A.

Failure to pay dividends upon preferred stock made operative restrictive covenant of preferred stock issue prohibiting payments on common stock when cumulative dividends on preferred were in arrears.

The last dividend paid on the preferred stock was during the fiscal year May 1, 1932 to April 30, 1933 (R. 31). On June 1, 1936 the preferred stock became payable (R. 50). By the terms of the restrictive covenant contained in the amendment to the Articles of Incorporation authorizing the issuance of the preferred stock (set out in the petition) no dividends could be paid on the common stock until all cumulative dividends on the preferred had been paid or a sum sufficient for the payment thereof set aside and appropriated to such payment (R. 49). It is undisputed that the Petitioner has paid a large portion of its bond indebtedness out of assets other than those represented by profits and earned surplus. It has used working capital and depreciation reserves.

The last dividend on the preferred stock was paid on October 15, 1932 (R. 31). Exhibit 6 shows that thereafter they were accrued (R. 55-7). Inasmuch as the dividends on the preferred stock had accumulated since 1933, no dividends could have been paid on the common stock during the tax years in question.

The facts of this case are unlike *Helvering vs. Northwest Steel Rolling Mills, Inc.*, 61 S. Ct. 109. In that case the restriction was created by statute. In this case the restriction is provided for in express language in the Articles of Incorporation and in the certificates. Statutory prohibitions against payment of dividends are subject to

modification by the State. Provisions in Articles of Incorporation determining the rights between classes of stockholders constitutes a contract between such stockholders and the corporation.

Lehigh Structural Steel Co. vs. Commissioner (C. C. A. 31), 127 F. (2d) 67;

Allen vs. Francisco Sugar Co., 110 A. 37, 38;

Dow vs. Northern Railroad, 36 A. 510, 512;

Allen vs. White, 103 Nebr. 256, 171 N. W. 52;

Johnson vs. Bradley Knitting Co., 228 Wis. 566, 580, 584, 280 N. W. 688.

B.

Construction placed on contract by parties is the best evidence of its meaning.

The restriction in the trust deed is set out in the Petition under the heading "Statement of Matters Involved."

The Petitioner contends the restrictive clause prohibits payments of dividends upon the common stock until all bond maturities and interest have been provided for out of earnings and that inasmuch as since the date of the bond issue payments of principal and interest were in excess of earnings plus the earned surplus existing at the date of the bond issue, the Petitioner was prohibited from paying dividends on its common stock during the tax years in question.

The construction to be given the restrictive clause depends upon the meaning of the phrase "provided for". When the restrictive covenant is read, the question naturally arises "Provided for how?", or "Provided for in what way?"

The Tax Board construed the words "provided for" to mean paid. The Petitioner construes the words "provided for" to mean *earn*, or *provide for out of earnings*. Obvi-

ously the words "provided for" literally construed do not mean paid and just as obviously do not mean earned.

Likewise, if we use a synonym for provide, such as procure, we run into the same difficulty; procure how?—by earning? by borrowing?

It seems obvious that the court must in some way try to find out what the parties to the trust deed meant when they used the phrase "provided for".

The parties to the trust deed construed the words "provided for" in the restrictive clause to mean "earned". Henry Marin, trustee of the bond issue, testified that he had several conversations with Mr. Smith, president of the Petitioner, about the construction to be given the restrictive clause (R. 38). In 1936 they both agreed that "there wasn't going to be any prospect of any dividends being paid on the common stock because earnings weren't sufficient to take care of it * * *" (R. 39).

Henry Marin, trustee, testified further as follows: (R. 39-40)

"Q. Will you state what your understanding was with Mr. Smith, as to whether the Central West Coal Company would pay dividends?

* * *

"A. My understanding was they couldn't pay dividends.

"Q. Why?

"A. Because they didn't have any surplus out of which to pay those dividends."

If payments of interest and principal of the bond issue were charged against "earned surplus", no surplus existed, as Mr. Marin testified, out of which dividends could be paid. If, however, they had not construed the trust indenture to mean that no dividends could be paid unless interest and principal had been "provided for" out of earnings, a surplus would have existed out of which dividends could have been declared.

The fact is undisputed that from 1931 to 1938 no dividends were paid upon the common stock. Therefore, the construction of the restrictive covenant adopted by the parties to the contract was in fact carried out. The rule of law is well established that the construction placed upon a contract of the parties is the best evidence as to its meaning.

Section 2034, *Page on the Law of Contracts*, 1919-1920 Supplement and Second Edition;
 13 C. J. 546, Par. 517, Contracts;
Leavitt vs. Windsor Land & Investment Co., 54 Fed. 439;
Chicago vs. Sheldon, 75 U. S. (9 Wall) 50, 54; 19 L. Ed. 594.

The trust deed also provides that if the parties to the indenture are unable to agree as to the meaning of the restrictive covenant, the determination by a disinterested accountant of good standing shall be conclusive.

The trustee and Petitioner agreed from the beginning that the restrictive covenant in the trust deed prohibited any payment of dividends until all bond maturities and interest had been paid out of earnings. Now, if they had disagreed, and the accountant to whom the dispute was referred had determined that dividends could not be paid on the common stock unless the bond maturities and interest had been met out of earnings, it must be conceded there would be no question as to the meaning of the restrictive covenant. Can it be said that the agreement of the parties, thereby saving reference to an accountant, has any less binding effect?

At the time the trust deed was executed in 1928, the tax law in question was not in existence. The parties to the contract obviously had in mind the protection of bondholders. It was desired that the assets of the corporation

be not dissipated in dividends to the prejudice of bondholders. The trustee testified (R. 38):

"At the time the bond issue was arranged for, the bank of which I was cashier was interested in buying bonds for disposal to our customers, and I was also co-trustee under the terms of the bond issue, so that I had an interest in that way as well, and talking with Mr. Smith I was particularly interested to know just how these funds were going to be handled, because after all we were selling or we did sell to customers \$100,000 worth of these bonds, and that was one-fourth of the issue, and naturally we wanted to know there wasn't going to be any dividends, there weren't going to be any dividends paid which would tend to impair the security back of these bonds or make it difficult to pay those bonds as they matured beginning, I believe, in about 1931."

The \$400,000 of bonds issued by Petitioner matured in series—\$40,000 in 1931 and \$30,000 annually thereafter. What good purpose could possibly be served by a restrictive covenant which would permit Petitioner, by paying a single year's maturity, to declare a dividend up to the amount of earned surplus? Bondholders would have no protection so far as depleting the assets of the corporation is concerned.

What the parties undoubtedly had in mind was that the assets existing at the time of the execution of the trust deed were to remain as security for the payment of the bonds. Dividends could only be paid after bond maturities and interest had been provided for out of earnings. Unless that interpretation is given, the restrictive covenant serves no useful purpose. As between two possible constructions, the one more fair and reasonable should be adopted.

Par. 2053, *Page on the Law of Contracts* (2d Ed. 1920).

The Circuit Court of Appeals rejected the construction adopted by the parties because of the finding by the Tax Board "that the parties had never looked to earnings for payment, but that annual payments had been made out of working capital, reserves and proceeds from the sale of assets as well as earnings."

The testimony is undisputed that bond maturities were paid first through profits and after those were exhausted through moneys from working capital, sale of assets and depreciation reserve (R. 27).

Certainly because earnings were insufficient to pay bond maturities, and other funds had to be used, it does not follow that the parties did not intend that bond maturities were to be paid out of earnings before dividends could be paid on the common stock.

Wherefore, Petitioner prays that certiorari to the Circuit Court of Appeals for the Seventh Circuit be granted and the decision of that court in this case be reversed.

Respectfully submitted,

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